Trading Cattle
…. from a meat market perspective
A commentary by Kevin Bost

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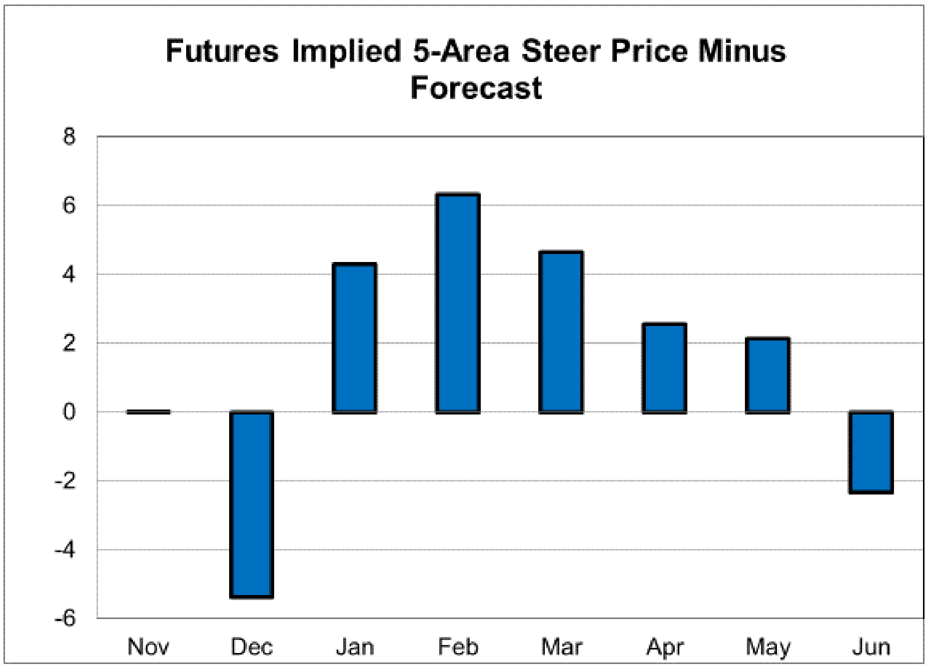

Mainly by virtue of the picture at left, I am interested in the long side of the December contract; the short side of the February contract; and in the long December / short February spread.

Let's start with the first possibility. While the combined Choice/Select cutout value has leveled out for the time being, I doubt that it is poised for a protracted decline just yet. My guess is that beef demand will be strong through the holidays; even if it merely follows a normal seasonal course between now and then, the combined cutout in the middle of December will be a couple dollars higher than it is today. The influence of the normally "weak links" (50% lean trim, strips/short loins/top butts, chuck cuts, bottom round flats) looks as though it will be overshadowed by further strength in Choice ribeyes and tenderloins. Forward booking activity for December delivery has been brisk enough to support this notion. I am also assuming that spot packer margins will be near the average of the past three weeks. Why not? I see no statistical evidence that front-end cattle supplies will be materially larger in December than they are now. [True, the increase in the most recently-reported carcass weights was mildly surprising, but that single data point was not enough to alter the unmistakable trend.]

I notice that the discount in the December contract relative to the Five Area Weighted Average Steer price is extraordinarily wide for this time of year; at $2.30 per cwt, it is the second steepest since 1999, the last time that there was a major alteration in contract specifications. Since then, the average futures-minus-cash basis in the third week of November has been +$.49.

Thus, the December contract appears to be substantially undervalued. Respecting the near term chart, however, I do not intend to take on an outright long position above $119.00. This is the location of the nearest obvious support level, and the 40-day moving average lies in the neighborhood of $118.50. Also, I recognize that we are heading into a "pre-holiday buy week", which should make it a bit easier for packers to procure cattle at lower prices. Ideally, I would prefer to wait until we can discern just how much lower this week's cash trade might be.

Next, let's discuss the the third opportunity, the long December/short February spread. I intend to place a bet on this one tomorrow. Were it not for the firmness that I anticipate in the cash market after Thanksgiving, I would not be willing to make this trade. There are other considerations, though:

- Whereas the nearest major support level in the December contract lies about 150 points below Friday's closing trade, the nearest discernible support in the February contract is still 375 points away. By now, long funds are much more heavily situated in the latter.

- This spread reached a new low for the year on Friday at $6.17 per cwt, and has lost $2.72 in the last seven trading days. The fundamental justification for this move escapes me.

- Some historical perspective: going back to 1979 (when I made my first trade in the cattle market), the discount in the December contract has never been this wide in the third week of November. It appears to have made a downward shift since 2000, and since then it has averaged only $1.81, ranging basically from par to a $4.00 discount (excluding the very odd year of 2003). In the third week of December, the discount has averaged $1.96, and has been no wider than $5.00. Finally, since 1979, the December/February spread has moved upward between the third week of November and the third week of December 16 times, and moved downward 13 times….showing no seasonal bias in either direction.

Finally, the outright short position holds merit because it appears to be substantially overvalued. However, I do not intend to place a bet on this one until the market makes an attempt toward the contract high. I must say that given the extent of the pullback in the past week, it seems more likely that the contract high has indeed been established. In the same breath, though, I must also acknowledge that the trend still points upward, and the annual threat of severe weather always looms. Otherwise, there is a good chance that beef demand will slacken after the holidays, *if* forward pricing for first quarter deliveries begins to stiffen as I anticipate. Of course, demand almost always lets up after the holidays, but I'm talking about a greater than usual decline this time around. That would be reflected by a downturn in the seasonally adjusted wholesale demand index, which is due for such a downturn after a three-month upswing.

Forecasts:

	Nov*	Dec*	Jan*	Feb	Mar	Apr
Avg Weekly Cattle Sltr	615,000	578,000	598,000	587,000	591,000	606,000
Year Ago	604,000	574,900	576,100	581,400	596,800	599,600
Avg Weekly Steer & Heifer Sltr	485,000	456,000	471,000	467,000	472,000	487,000
Year Ago	482,000	459,300	456,000	458,000	476,500	481,100
Avg Weekly Cow Sltr	119,000	113,000	118,000	111,000	109,000	108,000
Year Ago	112,200	107,200	111,900	114,000	110,200	107,700
Steer Carcass Weights	896	890	886	880	872	857
Year Ago	915.6	903.3	894.0	881.3	871.8	849.0
Avg Weekly Beef Prodn	506	474	488	480	480	485
Year Ago	507.4	479.0	474.8	475.6	485.5	478.6

Avg Cutout Value	$204.25	$208.50	$207.50	$201.50	$215.00	$216.50
Year Ago	$179.30	$189.19	$192.21	$190.41	$213.29	$208.39
5-Area Steers	$122.75	$125.50	$123.50	$121.50	$126.50	$127.50
Year Ago	$108.22	$113.37	$119.90	$120.62	$127.39	$130.04

**Includes holiday-shortened weeks*

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